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UNCLAS SECTION 01 OF 02 COLOMBO 001633

SIPDIS

STATE FOR SA/INS
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MANILA FOR USADB

E.O. 12958: N/A
TAGS: KTDB BEXP ECON EINV ETRD EFIN CE ECONOMICS
SUBJECT: SRI LANKAN GOVERNMENT FINANCE-DOLLAR DEBT AND REFORM EFFORTS

Ref: (a) Colombo 001400

¶1. Summary: The Government of Sri Lanka (GSL) has requested proposals for a financial facility of up to $350 million to finance the budget deficit. The funds raised in this issue will ease pressure from the local money market and interest rates. The proceeds will be part of a Rs 329 billion (approximately $3.4 billion) gross borrowing program of the GSL for 2002. End Summary.

GSL to borrow $350 million

¶2. The Central Bank has requested proposals from international investment banks and local banks to raise $350 million in long-term debt. The minimum tenor of the loan is 5 years and proposals are invited in the form of either a syndicated loan, fixed rate bond or a floating rate note. The closing date for proposals is September 6. The Central Bank expects to borrow the funds during the last quarter of ¶2002. The funds will go to finance the GSL capital expenditure and to retire existing short-term government debt.

¶3. Sri Lanka will go for the debt issue, its largest ever in international markets, minus a sovereign debt rating. Although Sri Lankan officials have talked about seeking a debt rating, Treasury Secretary Charitha Ratwatte told the media a few weeks ago that the GSL would wait for the peace process to take root, then will seek a rating. Investment analysts in Colombo feel that Sri Lanka would likely get a below investment grade of B+ or BB+, close to India's BB rating, if it applies for a rating for long-term foreign currency debt.

¶4. The last time the GSL raised a loan from the international market was in 1997 when it raised $50 million through a two year floating rate note. In addition, in late 2001 and June 2002, GSL raised a total of $250 million through dollar denominated bonds sold in Sri Lanka. The last tranche of this issue in June 2002 was priced at six months LIBOR plus 193 basis points. The Central Bank is confident of receiving favorable bids for the current debt call. Citibank/Solomon Smith Barney, JP Morgan, HSBC and Standard Chartered Bank are among those expected to submit bids.

¶5. According to the Central Bank, the total gross borrowing program of the GSL for 2002 is Rs 329 billion (or about $3.4 billion). The proceeds from the $350 million (Rs 33.3 billion) international debt issue will form part of the borrowing plan, along with a $90 million dollar denominated Development Bond issued in the local market in June. In addition, the Government expects about $70 million (Rs 736 million) from concessionary foreign financing. The balance will be raised mostly in the local rupee market.

Development of a long-term yield curve

¶6. The retirement of some rupee debt with dollar proceeds is expected to improve market liquidity and further ease pressure on the interest rates, which have fallen considerably during 2002. In response to a reduction of key Central Bank short-term discount rates and improved liquidity, the entire Central Bank yield curve has shifted downwards by about 300 basis points between January and August 2002. Currently, short-term (3 month and 12 month) T-bill rates are at 11-11.5% while long-term rates vary between 13.3 percent for 4 year bonds and 14.4 percent for 6 year bonds.

¶7. In addition, the Central Bank has issued more long-term rupee bonds and the yield curve has been extended up to 6 years. In a bid to develop further the long-term yield curve, Central Bank is also expected to issue 12-year bonds this year. The Central Bank is said to be keen on issuing long-term debt in view of current low interest rate climate, but the timing and the features of the issue have not been decided yet.

Other financial sector developments

¶8. Meanwhile, the Prime Minster has appointed a Financial Sector Reforms Committee (FSRC) to fast track financial sector reforms. The Committee is reviewing key reforms identified at a recent conference hosted with the assistance of the IMF resident representative office in Colombo. The conference results included a series of recommendations. Some of the reforms considered by the FSRC are relaxation of controls on foreign exchange and the capital account, amendments to the banking act and monetary law act, strengthening bank supervision, relaxation of the statutory reserve ratio, development of debt instruments and the creation of a long term yield curve.

New legislation

¶9. In a separate move to control public finances, the GSL will introduce a wide-ranging Fiscal Management (Responsibility) Act. The purpose is to promote greater accountability and responsibility in all public offices. It will place government spending under strict scrutiny and will prevent finance ministers from giving out pre-election subsidies and inducements to voters. If extreme circumstances necessitate spending over-budget, the Finance Minster has to table a statement in Parliament justifying the action. Under the act, election manifestos of major parties are to be referred to the Central Bank to assess the long-term impact on government finances. The Central Bank should also investigate and comment on all government spending plans.

¶10. The law also would require the Finance Minister to present to Parliament a financial position report annually which will state GDP estimates and forecasts of other key economic variables. The Finance Minister is also expected to present to parliament a mid year GSL fiscal position report as well as the annual budget statement. The GSL soon plans to introduce several other laws or amendments to current legislation concerning the financial sector including regulations on monetary policy and banking, finance companies, stocks and securities, mortgage, and debt and loan recovery.
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